ESO 762

College of Agriculture and Home Economics
THE OHIO STATE UNIVERSITY

THE CHARLES FAMILY PARTNERSHIP:

A Case Study

Michael W. Woolverton

Assistant Professor of
Agribusiness Management

Department of Agricultural Economics and Rural Sociology
Ohio Agricultural Research and Development Center
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THE CHARLES FAMILY PARTNERSHIP

Greater and greater amounts of capital are flowing into production agriculture. Current estimates indicate the nation's farmers borrow more than $100 billion annually. As one major agricultural lender said, "...the bigger farms become, the more credit they need. And they get it."

The largest farmers in the U.S. represent only about 10 percent of the nation's 2.7 million farmers yet they produce an estimated two-thirds of all farm products. While average figures are difficult to come by, these farmers are large, in terms of number of acres farmed, and are getting larger. For the most part, large farmers are aggressive land buyers, financing new purchases with equity gains on land already owned. Many have become millionaires, primarily because of skyrocketing land prices.

University agricultural economicst point to economies of size, in purchasing and marketing as well as production, as the incentive for growth. Increasingly sophisticated manager-owners grow larger and more efficient as they adopt new technology at a fast rate. They back up larger acreages, new equipment, and innovative production practices with improved management techniques including long-range planning, marketing forward contracts, management and forecast advisory services, and advantageous organizational structures. Many farmers have found it to their advantage to integrate into activities related to farm production such as the input supply business and marketing of farm products.

The Charles Family Partnership, while unique unto itself, is fairly typical of this 'new breed' of farmers. Art Charles and his two sons, Jim and Frank, are partners. The base of their operation is a 900 acre cash grain farm in Northwestern Ohio. Art started farming in 1950. He has built the home place up to its present size by purchasing land as it has become available. In addition, the partnership rents 1200 acres of land, one-half on a cash rent basis. The other half is farmed on shares with the Charles' receiving 60 percent of the harvested crop and the landlords receiving 40 percent. Fertilizer, chemical and seed costs are split on a 60-40 basis. The Charles' pay the rest of the cash costs of production.

After graduating from The Ohio State University, Jim worked in the Ag Chemical business for about 10 years. He joined his father and Frank, also an O.S.U. graduate, in the farm partnership in 1970. Jim saw an opportunity to use some of the equipment owned by the partnership to apply and incorporate herbicides for neighbors. Soon he was also purchasing and applying fertilizer. The partnership invested some of its excess capital in the mid-70s in fertilizer and chemical storage facilities and related application equipment.

Frank is Art's younger son. However, he has been involved in the farming operation longer than Jim. The first winter after joining his father, Frank found himself with considerable slack time . He convinced Art to let him use the 300 bushel grain truck to haul grain to Maumee for themselves and for neighbors. Grain brings a premium over trucking cost when hauled to Maumee compared to the prices received at the local elevator. The business has grown. Frank now purchases most of the grain he hauls. He uses the partnership's grain dryer and storage facilities to condition grain bought at a discount in the local area.

Art is generally favorable toward the expansion of the partnership's off-farm agribusiness activities. He realizes the farm business alone will not support three families comfortably. He knows that his sons have acquired specialized knowledge and expertise that represent valuable non-balance sheet assets. He would like to see them continue to expand to build a firm that will sustain his grandsons and their sons. He believes production agriculture should continue to be the solid foundation of the partnership. His longtime goal has been to expand the size of the farm.

Art has just been given the opportunity to purchase a neighbor's adjoining farm that would boost the size of the home place to 1280 acres...two sections. The purchase price of the 320 acres is $2,300 per acre. On the land is a house worth $50,000 and a good set of buildings which include facilities to support a farrow-to-finish hog operation. The hog set up includes a central farrowing house and open-front confinement nursery and finishing houses. The neighbor, who is planning to retire in Florida after he sells his farm, told Art he farrows about 100 litters per year. In the most recent year gross income from the hog operation was about $56,000. Off-farm sale of crops grossed $82,400.

Art has always liked hogs, even though he hasn't raised any in years. Art and his wife paid off several land mortgages in the early years with money made raising hogs. But the hog business has not been profitable recently. Art suspects the reason his neighbor has decided to retire now is that he lost money selling market hogs this year. Plus, the fellows at the local coffee-shop had said that Jerry Lawson, his neighbor's hired man who helped with the hog operation, was going to move to Lima to work in the Chrysler plant making the new Army tank.

Art realizes that the hog business is cyclical in nature. He just read the 1981 outlook on hogs by Herb Hadley in the 1981 Outlook Guide, Ohio published by the Agricultural Economics and Rural Sociology Department at the Ohio State University (see Exhibit 1). He feels optimistic about the hog business.

"Besides," he thought, "We're big enough to absorb the down years. Our knowledge of marketing alternatives and lower corn production costs will give us some advantages my neighbor didn't have. Frank's wife would really like to live in that house. Then Frank would be right there to keep an eye on the pigs."

Art drove into town to tell Frank about his ideas. Frank's wife was just leaving for work but stopped to listen for just a moment. She didn't like the idea of moving to the country, she would have to drive back and forth to town for work and for her bridge club. She liked the idea of living on a hog farm even less.

"I can't stand the smell. No way!" She said as she slammed the door for emphasis on the way out.

Frank liked the idea of buying more land but didn't like the idea of managing a hog operation.

"My grain buying and trucking business is really taking off. In fact, I wanted to talk with you about buying another rig and hiring a driver. I can buy more grain right now than I can haul and we're making good money at it."

Art was disappointed that Frank wasn't interested in the hog business but listened patiently while Frank explained his plan for expanding their grain hauling operation. Frank wanted to purchase another Kenworth rig similar to the one the partnership now owned. The new tractor-trailer combination would cost $60,000. Frank expects to have to pay $18,000 per year to hire a good driver. Other operating expenses are expected to increase $7,500 per year. The increase in grain merchandising profit is expected to be $40,000 per year. Because of his approach to trade credit Frank does not anticipate needing any additional operating capital. Frank is projecting a five-year lifespan for the new rig with salvage value of $10,000.

As they walked out of the house Art promised to look into financing for the new truck after he talked with Jim about it. Frank climbed into the cab of the Kenworth, which had been loaded with soybeans bound for Maumee the night before.

"I hope Jim says something to the old man about his will," Frank thought as he saw Art get into his pickup.

Jim was checking his inventory of liquid fertilizer stored in big upright tanks when he saw Art drive in.

"Hi Dad! Let's go in where it's warm. Coffee should be ready by now."

They walked into the cluttered little office built, seemingly as an afterthought, into the building which served as a warehouse for dry fertilizer and agricultural chemicals. Product inventories were low now and the building held several fertilizer spreaders and sprayers in various stages of maintenance and repainting in preparation for the busy season ahead.

The hot coffee felt good going down but before Art could mention the neighbor's farm, Jim put a brochure with the picture of a sprayer with huge tires into his free hand. (See Exhibit 2).

"That's a Big-A Floater. We need to buy one." said Jim matter-of-factly.

"How much?"

"About $70,000," answered Jim. He went on to explain how the specialized all-weather applicator would not only lengthen the application season but allow them to cover more acres per day.

"The major problem with one of these outfits," explained Jim, "is keeping it supplied with fertilizer and chemicals."

Jim planned to overcome that problem by converting a couple of the old spray rigs to supply shuttles. Fertilizer and chemicals would be mixed at the plant to fit the specifications of each customer then the mixture would be hauled to the Big-A for application.

"Our goal will be to keep the monster in the field all the time. We won't waste time driving back to the plant for reloading."

Art told Jim that he would ask the banker about a loan for the new equipment and mentioned Frank's proposal to expand the trucking operation. Jim thought the banker might want more details on the Big-A. Jim estimates the investment would cause his operating capital requirement to increase by $10,000 but the net cash inflow ought to increase by $22-$25,000 per year. Because of the corrosive nature of fertilizer and the tough operating conditions, Jim estimates the Big-A salvage value at the end of five years to be zero.

Over a second cup of coffee Art explained the neighbor's proposition and his hope that the partnership could expand into hog production.

Jim sipped his coffee thoughtfully and said, "I don't think we should ever turn down an opportunity to buy land and the hog business would probably make sense. I mean we could put a lot of our corn through them. I can buy all sorts of animal health products wholesale. Frank could even haul the hogs to market for us. Probably need to buy a double-decker trailer. But Dad, even if I had time to look over that operation, I'm just not a hog man and Frank's not interested. Unless you would want to run it, we'd have to hire somebody." Jim shrugged his shoulders and finished off his coffee.

Art was trying to think who they could hire when Jim broke into his thoughts. "Say, Frank's worried about something and I promised him I would talk with you about it. You see, he's worried that if something happens to you we'd be in trouble. He and I would have to reorganize the partnership and since most of the land is in your name we'd have to pay some huge taxes. We might have to sell off some of the land."

Art felt anger well up in him, he thought, "First, they won't go along with me on the hogs and now they're ready to pick over my bones."

He rose to leave and said, "Look, don't worry about it. I'm not ready to die yet."

Jim could barely see through the dirty office window but he didn't need to see very well to tell by the way his father walked he was angry. Jim heard him slam the pickup door and spin the rear wheels on the gravel as he drove out of the plant and turned onto the main road leading to town. Jim picked up the phone to make a call.

Art's first stop was at the local Federal Land Bank Association office. He found the current terms on land loans to be as follows:

> 10 percent rate of interest; loan limit of 80 percent of the value of the collateral (usually the land being purchased); maximum length of loan 35 years; interest and principle are payable in annual installments. In addition, the Federal Land Bank requires the purchase of Association stock worth five percent of the gross amount of the loan.

The Land Bank lending officer indicated their board probably would approve a loan to the Charles family but was quick to add he couldn't promise anything. He took the balance sheet and income statement Art had brought with him. See Exhibits 3 and 4. He asked Art a series of questions about the operations of the partnership as he completed the loan application form. The banker said to check back in about ten days as Art signed the loan application.

Art then walked next door to the local Production Credit Association office. The Federal Land Bank and the P.C.A. are both part of the Farm Credit System. But at the local and even the regional level they are organized and administered separately. The local P.C.A. had its own board of directors, mostly farmers, some friends of Art's.

Willard Jones, the P.C.A. manager, had moved into town to take over the P.C.A. about seven years ago. He was still considered to be sort of a newcomer by most of the old-time residents of the community. But Will was a pleasant fellow and the boys at the coffee shop thought he was doing a good job. He quoted Art the following terms:

> Short-term loans; renewable and unsecured, 14 percent interest; borrower must purchase stock in the local P.C.A. equal to five percent of the loan.
>
> Intermediate term loans; seven-year maximum length; will loan up to 80 percent of the value of the investment; 13 percent interest; interest and principle payable in annual installments; stock purchase requirement the same as for short-term loans.

Will told Art he thought the P.C.A. could loan the partnership money for the Big-A and the new truck but before he committed the Association he would need to compute the net present value of each alternative.

"Another thing, I'd like to loan you all your operating money this year, Art, instead of just part of it. I think we can do a better job of servicing customers when we have all their loans."

Will went on to explain that the F.I.C.B. auditors from Louisville had recommended to P.C.A. managers to complete a projected cash flow statement for each customer to get a better reading of repayment capacity.

"I know you're not one of them Art, but some farmers are stretched mighty thin. One bad year and they get in trouble. We just want to help them keep from getting in too deep." Will paused as he pulled some forms from his desk drawer. "I can fill out most of these from your balance sheet and income statement. Mind if I ask a few questions to complete the forms?"

Art answered Willard's questions as best he could. The form Will completed is shown as Exhibit 5. Will told Art he would complete the blank cash flow worksheets later in the day. See Exhibits 6 and 7.

"Check back towards the end of the week, Art. I will have had time to analyze your loan application and present it to our loan Committee." Will smiled broadly as he stood and held out his hand for Art to shake.

Art noticed the sun had taken some of the chill out of the air as the door to the P.C.A. closed behind him. He left his truck parked in front of the Land Bank and started to walk toward the cluster of buildings that represented the commercial district. He waved to several good friends and nodded at some acquaintances as he walked the short distance to the modern looking State Bank that anchored the little town.

Art and Fred Solomon, Vice-President and Farm Loan Representative at the State Bank, had been friends for years.

Fred greeted Art warmly when he walked into the bank and motioned for Art to join him. Fred's desk was located on the Officer's side of the bank, that part separated from the teller's windows and customer service desk by a wooden railing. Art felt himself sink into the rich carpeting as he walked over to the leather upholstered chair setting beside Fred's desk. Only after he shook Fred's hand and sat down did he think to check his boots for mud.

"Did you come to put some in or take some out?" Fred asked a smile on his face.

Art explained the partnership's current situation. He reviewed the land purchase opportunities and his hopes for the hog operation. "The boys don't seem to be interested in hogs but I'm thinking I'll go ahead with it anyway if we buy the place." Art then described Frank's and Jim's plans for expanding their operations. "Oh, by the way, we might as well talk about another operating loan for next year. Seems like I just got last year's paid off but it won't be too long before we'll have to buy fertilizer, chemicals, and seed. In fact, salesmen are already starting to call on Jim."

Fred explained the bank was currently lending under the following terms:

Short-term loans, renewable and unsecured, 15 percent interest.

Intermediate term loans, five year maximum length; will loan up to 90 percent of the value of the investment; 14 percent interest; interest and principle payable in annual installments.

"Art, I think we can work with you on the Big-A and the Kenworth. How much operating capital will you need this year? Do you want us to set up a line of credit for you on that like we did last year?" asked Fred.

"Well, let's see...expanding in fertilizer and trucking will add some to it. I guess we'd better set up a line of credit for about $750,000 and hope we can collect fertilizer and chemical accounts receivable faster this year. But you know if we do buy that farm and go into the hog business we may need to go on up to a million." Art looked at Fred, half expecting him to say that was too much.

"It sure takes a lot of money to farm these days doesn't it Art? I think we can go along with you on that. But you know, it just kills me to give so much of your business to those city bankers."

"What do you mean?" asked Art, a concerned look on his face.

"Well, the State Bank isn't very big as banks go. Our upper loan limit to an individual or in your case, a partnership, is $200,000. That's all we can legally loan you out of our funds. The rest of it is called a loan override. We pass it along to our correspondent bank, a big city bank in Columbus. We service the loan for them for a small fee. But most of the money you'll borrow this year will come from them and the interest you'll pay will go to them through us." Fred paused as Art thought about having his business handled by a big city bank.

Art was still thinking when Fred brought up the idea of changing the partnership to a corporation.

Fred told him, "Since you want to expand and you are getting into some other businesses, there might be some advantages for you and the boys in setting up a corporation."

Fred then searched through his files and found a publication he had received from Cornell University. He had his secretary copy part of the publication.

"This information is probably a little out of date and it's about New York State but it'll give you the general idea. You'll need to talk with a lawyer here in Ohio to get a corporation set up anyway," Fred said, as he stapled the pages together and handed them to Art. (See Exhibit 8).

Art glanced at the top sheet of the article Fred handed him and saw the words "estate planning".

"I'll have to take a look at this," he thought as he tucked the papers into the folder he carried.

As Fred walked him to the door, Art glanced at the bank clock and noted it would be almost noon, dinner time, by the time he got home.

On the way back to his pickup Art found himself thinking back to the days when he supported a wife and two young sons on 120 acres that he owned free and clear. As he started his pickup he thought, "Farming sure has gotten a lot more complicated."

EXHIBIT 1

Herbert Hadley, "Hogs," 1981 Outlook Guide, Ohio, ESO 747, AERS, College of Agriculture and Home Economics, The Ohio State University, Columbus, Ohio, October 1981.

HOGS

Hogs and pigs on farms in the 14 major producing states numbered 55.56 million head on September 1, 1980. This was 3 percent less than September 1, 1979. The number kept for breeding was down 10 percent. Market hogs and pigs were 2 percent below a year ago. In Ohio, the total number of hogs on farms September 1, 1980 was 7 percent less than a year earlier with market hogs down 6 percent and breeding hogs down 12 percent. The hog cycle seems to be turning down.

--The June-August pig crop of 20.4 million was 10 percent under one year ago. Hog producers intend to farrow 2.7 million sows during September-November, 10 percent less than the same period last year. Farmers said their December-February intentions to farrow would be 7 percent less.

-Per capita pork consumption of 75-76 pounds for 1980 is expected. In 1981, the supply of pork may be around 67 pounds per person. Consumer acceptance of pork has been excellent and should continue in 1981.

Review of 1979

--Hog slaughter the first half of 1980 was eighteen percent higher than a year earlier. Third quarter slaughter was up about 8 percent from last year and the fourth quarter may be -2 to +1 percent from last year.

--Prices for barrows and gilts at seven Midwestern markets ranged from $28.94 in April to $48.40 in August. Prices are expected to average under $40.00 for the year reflecting more pork, more poultry, and less beef.

Returns from hog operations, excellent in 1978 and early 1979, were well below the breakeven price during much of 1980. A reduction in hog numbers will continue in 1981 with a reduction of around 10 percent for the market year.

--Prices for this fall should average in the mid to upper 40's for barrows and gilts at the 7 major markets. Feeder pig prices can be expected to average around $30 per head for 50 pound pigs.

FARROWINGS AND PIG CROP, 14 STATES

	Sow Farrowing			Pig Crop	
	1979	1980	1980/79	1979	1980
	1,000 Head		Percent	1,000 Head	
Dec.-Feb.	2,660	2,745	103	18,266	19,685
Mar.-May	3,486	3,391	97	24,994	24,856
June-Aug.	3,159	2,853	91	22,606	20,453
Sept.-Nov.	3,053	2,741	90	24,363	---
Dec. '80-Feb. '80	2,564	2,745	93		

Future Production

--On September 1, market hogs on hand were down 2 percent. By weight groups, hogs under 60 pounds were 9 percent less than a year ago, 60 to 119 pounders were 1 percent higher, 120 to 179 pounders were up 4 percent. The reduction in numbers are on a large base with record numbers of hogs last year.

--Intentions to farrow sows in the September-November period were down 10 percent and December-February farrowing intentions were 7 percent under a year earlier. Therefore, pork supplies through mid-1980 should be 7 to 10 percent less if average litter size is achieved. Ohio farmers cut back more than the 14 state average.

--Supply levels in the last half of 1981 depend on the spring pig crop. It may also be below 1980 depending on the number of gilts kept, corn and meal prices, and profitability of the swine business. Feed margins are not favorable. A breakeven price to cover all costs of around $53 cwt. may be needed with $3.00 per bushel corn. The hog corn ratio in mid-September was an unfavorable 14.7. Considerable improvement is needed in hog returns before any turn around or expansion takes place. Hogs may be marketed at lighter weights cutting the total poundage of pork marketed.

--Some interest in expansion may start by late 1981 but more likely in 1982 if profits are available. In the meantime, new facilities will be used but some cutback in older establishments will continue. Feeder pig producers experienced low prices in early 1980 and may cut back production in 1981.

Outlook for Prices

--Hog prices for the rest of 1980 may range from $42 to $45 per cwt. as large numbers of hogs come to market. Some strength in demand comes from lower beef supplies. Negative factors are plentiful supplies of both broilers and turkeys.

--Prices for barrows and gilts during the first and second quarters of 1981 may average $46 to $48. Prices for the year may average near $50 per cwt.

--Stronger corn prices has put pressure on feeder pig prices. The demand for feeder pigs will be weaker with higher corn prices but will get some strength from higher slaughter hog prices.

HOG AND PORK PRICES AND PORK CONSUMPTION

Year	Barrows & Gilts Avg. Price in 7 Markets	U.S. Average Retail Pork Price	Pork Consumption Per Person
	$/Cwt.	¢/Lb.	Lbs. Carcass Wt.
1970	21.95	78.0	66.4
1975	48.32	134.6	56.1
1977	41.07	125.4	61.5
1978	48.49	143.6	61.4
1979	42.06	144.1	70.2
1980 a/	39.00	135.0	75.0

a/ Estimated.

Marketing

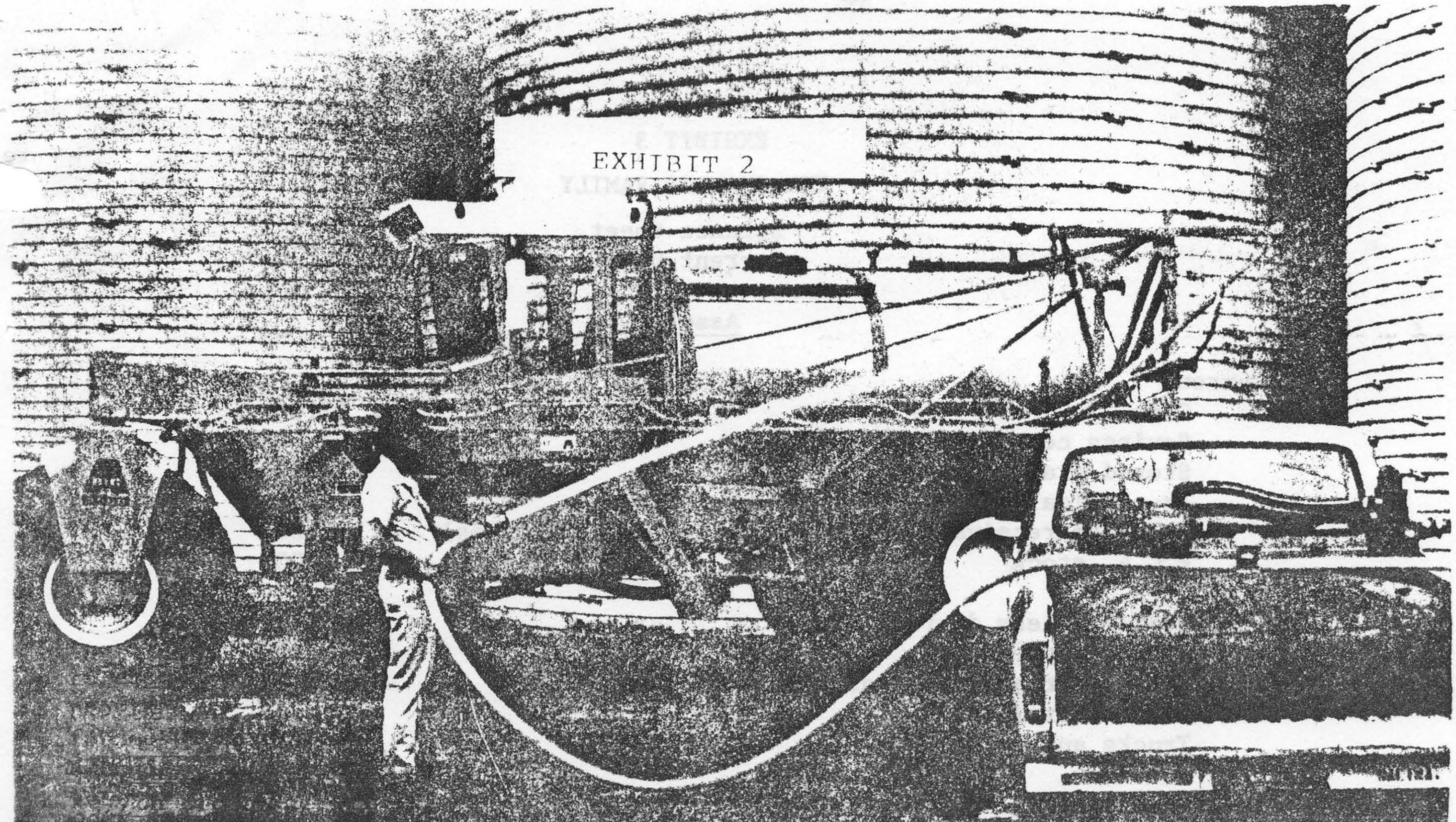
--Merchandising decisions will greatly influence the livestock producers profit or loss. Selling at lighter weights will reduce costs. Some producers may want to look at reducing price risk through hedging or contracting if they can lock in a profit. Well financed hog producers who go from farrow to finish may want to remain in a cash position. Large volume finishers may want to hedge their position.

Longer Run Outlook

--The retraction phase of the hog cycle has started. When budgeting for expansion, long run price relationships of corn and hogs need to be considered. The hog cycle still seems to work. It generally takes 1 to 2 quarters of low or high prices to recycle the actions of hog producers.

--Profit margins encouraged expansion in 1978 and early 1979. Continued cutback in 1981 is anticipated. The short term outlook is not favorable. Hog producers may continue to produce as long as variable costs are met. In the longer run, profits will return. Consu acceptance of pork is good and record quantities are being consumed. Since there is a considerable lag between plans for expansion and actual expansion, plans need to be made early. Many hog producers who ordered housing and facilities in 1978 looking at $5[illegible] cwt prices delivered their first hogs to market in 1980 for $39. The long term outlook of the hog industry is bright. Viable leadership in the industry is giving leadership to a profitable industry. Pork acceptance by consumers is excellent and should continue in the future.

EXHIBIT 2



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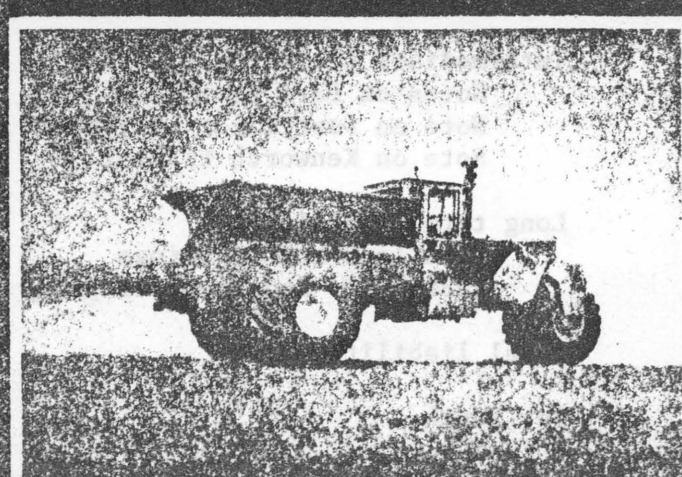

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EXHIBIT 3

THE CHARLES FAMILY

Balance Sheet
Current Date

Assets

Current	
Cash	$ 47,000
Savings certificates	162,000
Stored grain	275,000
Ag-chemical inventory	35,000
Accounts receivable (80% due to Ag-chemical sales)	102,000
P.C.A. stock	6,000
Intermediate (less depreciation)	
Farm equipment	227,000
Fertilizer and chemical equipment	131,000
Tractor-trailer	22,000
Trucks and cars	24,000
Long term	
Farm land - 900 acres at market	1,800,000
Fertilizer and chemical plant	130,000
Houses and buildings	180,000
Total Assets	$3,141,000

Liabilities and Net Worth

Current Liabilities	
Accounts Payable	$ 57,000
Notes Payable	45,000
Operating Note (P.C.A.)	117,000
Intermediate Liabilities	
Notes on farm equipment	160,000
Note on fertilizer equipment	91,000
Note on Kenworth tractor	17,000
Long term Liabilities	
Farm land and buildings	885,000
Fertilizer and chemical plant	79,000
Total liabilities	$1,451,000
Net Worth	$1,690,000
Total Liabilities and Net Worth	$3,141,000

EXHIBIT 4

THE CHARLES FAMILY

Income Statement
Ending Current Crop Year

Sales	
Farm crops	$ 44,000
Government payments	17,000
Fertilizer and chemicals	670,000
Grain	1,570,000
Total receipts	$2,697,000
Cost of Goods Sold	
Operating Expenses	
Farm	$ 411,000
Fertilizer and chemicals	640,000
Grain merchandising	1,530,000
Fixed Expenses	57,000
Total Expenses	$2,638,000
Net Income from farm and agribusinesses	$ 59,000
Non-Partnership Income	
Non-partnership earnings of partners	$ 6,000
Wages of spouses	15,500
Interest and dividends	13,750
Net non-farm income	$35,250
Net Income	$94,250

Statement of Partnership Equity
Ending Current Crop Year

Net Worth beginning of period	$1,655,750
Net Income for period	94,250
Total Available	$1,750,000
Less withdrawals for partners	60,000
Net worth, end of period	$1,690,000

EXHIBIT 5

P.C.A. Loan Information

Enterprise Information

Corn	1200 acres	110 bu./acre average yield
Soybeans	900 acres	30 bu./acre average yield

Notes: 500 acres of corn owned. 400 acres cash rented at $100 per acre. 200 acres farmed on shares 60/40.

400 acres of soybeans owned. 200 acres cash rented at $100 per acre. 200 acres farmed on shares 60/40.

Financial Information

Schedule of Liabilities

Lender	Original Amount	Term	Interest Rate	Annual Payment	Current Balance
PCA	Operating	-----	10 3/4	-----	$117,0[illegible]
Implement Dealer	$160,000	4 yrs.	11 1/2	$40,000 + interest	160,000
Finance Company (Fertilizer Equipment)	120,000	5 yrs.	9	$20,000	91,000
State Bank	43,800	3 yrs.	8	$17,000	17,000
W. Harris (Land Contract)	358,000	20 yrs.	5	$17,000 + interest	290,000
United Insurance (Land)	650,000	30 yrs.	7	$52,390	595,000
American Petroleum (Fertilizer & Chemical Plant)	100,000	20 yrs.	6	$ 8,720	79,000

Notes: Also borrows operating capital from the State Bank. Last year borrowed approximately $600,000 on line of credit. Paid it off at the end of the crop year. Current balance outstanding zero.

Last year used about 1200 hours of seasonal hired labor. Paid about $5 per hour.

Annual property tax about $15,000.

NAME____ EXHIBIT 6

CORN

P.C.A. Cash Flow Projection for 19__

Address of farmland____

County______________________________ Township______________________________

PROJECTED INCOME:

Number of acres	________	
Projected yield per acre	________	
Total projected yield on this farm	________	
Projected price per bushel	$________	
Total Projected Gross Income		$________

PROJECTED PRODUCTION COST <u>PER ACRE</u>:

CASH COSTS

Hired Labor	________	
Machinery repairs	________	
Fuel, oil, and grease	________	
Seed	________	
Fertilizer and lime	________	
Chemicals	________	
Machine hired	________	
Crop insurance	________	
Interest on operating capital	________	
Miscellaneous expenses	________	
Projected production cost per acre	________	
Total Projected Cash Costs		$________

OVERHEAD COSTS

Machinery and Equipment	________	
Land Charge	________	
Management Charge	________	
Total Projected Overhead Costs		$________
Total Return Above Cash Costs		$________
Total Return Above All Costs		$________

NAME____________________ EXHIBIT 7

SOYBEANS

P.C.A. Cash Flow Projection for 19__

Address of farmland____________________

County____________________ Township____________________

PROJECTED INCOME:

Number of acres . . . . ____________

Projected yield per acre . . . . ____________

Total projected yield on this farm . . . . ____________

Projected price per bushel . . . . $____________

Total Projected Gross Income . . . . $____________

PROJECTED PRODUCTION COST PER ACRE:

CASH COSTS

Hired Labor . . . . ____________

Machinery repairs . . . . ____________

Fuel, oil, and grease . . . . ____________

Seed . . . . ____________

Chemicals . . . . ____________

Fertilizer and lime . . . . ____________

Machine hired . . . . ____________

Crop insurance . . . . ____________

Interest on operating capital . . . . . . ____________

Miscellaneous expenses . . . . ____________

Projected production cost per acre . . . . ____________

Total Projected Cash Costs . . . . $____________

OVERHEAD COSTS

Machinery and Equipment . . . . ____________

Land Charge . . . . ____________

Management Charge . . . . ____________

Total Projected Overhead Costs . . . . $____________

Total Return Above Cash Costs . . . . $____________

Total Return Above All Costs . . . . $____________

EXHIBIT 8

Richard A. Brock, Eddy L. LaDue, and Robert S. Smith, Preincorporation Considerations for the Farm Firm, A.E. Res. 76-28, Department of Agricultural Economics, Cornell University Agricultural Experiment Station, Cornell University, Ithaca, New York. December 1976.

ADVANTAGES AND DISADVANTAGES OF THE CORPORATE FORM

In determining whether a farm business should use the corporate or some other form of business, the potential advantages and disadvantages of the various forms must be evaluated in light of the specific characteristics of the business. Specific attributes of the corporate form may be more or less important for farms than for other types of businesses. The advantages and disadvantages normally listed for incorporation are listed below and discussed in light of the experience of the farms studied.

Advantages of the Corporate Form

A corporation, unlike the sole proprietorship and the partnership, is a separate legal entity with its own rights and duties. It is a "creature of state law" with the power to make contracts and hold property in its own name. Even though a corporation acts through human agents, its existence as an entity is an important idea that helps explain the legal position of a corporation.

Closely held farm corporations are sometimes called partnerships in corporate form because the owners are generally associated as partners in the management of business operations. However, a corporation, carefully structured to the needs of its owners, can retain some of the advantages of a partnership and gain some advantages not available to partnerships.

Advantages frequently cited for adoption of the corporate form include the following:2/

1. Division of ownership
2. Continuity of operation
3. Centralized management
4. Estate planning
5. Limited liability
6. Employee benefits
7. Credit status.

2/ For example, see R. S. Smith, Incorporation of the Farm Business. Cornell Extension Bulletin 1016, New York State College of Agriculture, Cornell University, November, 1965; or O'Bryne, Kransz, Harl and Jurgenson, The Farm Corporation. North Central Regional Extension Publication No. 11, Iowa State University Cooperative Extension Service, Ames, Iowa, February, 1973.

The first four advantages stated are interrelated and, thus, will be discussed jointly under division of ownership.

1. Division of Ownership

Ownership in a corporation is represented by shares of stock. These shares can be divided among stockholders in any manner desired. Because the ownership can be held and divided as shares of stock, the corporation has the following advantages:[3/]

a) Stock certificates provide a clear-cut and business-like manner of determining ownership

b) The farm can continue to be operated as a unit since ownership can be transferred as shares of stock

c) Sons or other interested individuals can be brought into the business in a gradual manner; ownership can be transferred to them as they become old enough to share in the management and responsiblity of the business

d) The parents can gradually retire from the farm by transferring stock to the children over a period of time.

With these advantages in mind and a desire to see if the underlying reason farms incorporate is to accomplish estate planning objectives (as is sometimes stated[4/]), the farmers interviewed were asked to indicate their primary reason for incorporating (Table 1).

Table 1. REASONS FOR INCORPORATING FARM BUSINESS
51 Corporate Farms, New York, 1974

Reason	Number of Farms	Percent of Farms
Estate planning	25	49
Clear-cut division of ownership	15	29
Tax advantages	6	12
Work son into business	3	6
Other	2	4
	51	100

Almost half of the farms studied incorporated for estate planning reasons. Fifteen farms stated that division of ownership by shares of stock was what made the corporate form appealing to their farm operation. Closely tied to these reasons is that of working the son or sons into the business. The two "other" reasons included (1) credit status and (2) to change accounting methods.

3/ R. S. Smith, op. cit. p. 5.

4/ Neil Harl, Farm Estate and Business Planning. Agri-Business Publications, Glenview, Illinois, 1973, p. 74.

A primary advantage of the corporate form for estate planning is the ability to divide the estate among farming and non-farming heirs in any desired configuration. Thus, the data in Table 1 indicate that 84 percent (43 out of 51) of the farms surveyed incorporated for reasons attributed to division of ownership by shares of stock.

2. Limited Liability

Although limited liability is generally considered the major advantage of incorporation[5], none of the farms mentioned this as being their primary reason for incorporating. As defined by McCord and Vazzana, limited liability means:

a) insulation of the individual assets of the proprietor or shareholder against corporate debts; and

b) insulation of the corporate assets against the claims of creditors of the individual proprietor or shareholder.

In a sole proprietorship or partnership, the owner or each of the owners is personally liable for the contractual or tort liabilities of all the owners and employees. It is also generally true that in a partnership all partners are personally liable for the acts of any one partner. If one partner makes an unfavorable business agreement which results in a large financial loss, then all partners could lose their non-farm property as well as farm property.

The corporation avoids this personal liability. Although the corporation is liable for the contractual and tort liabilities of its employees, the corporate stockholder is not personally liable for the debts or liabilities of the corporation. His potential loss is limited to the amount he has invested in the corporation stock.

In non-farm businesses, the stockholders generally have large assets outside the business. Only four of the survey farms, however, mentioned significant non-farm investments.

On 33 of the 51 farms, the home of at least one shareholder was owned by the corporation. All notes and mortgages given by 26 corporations had to be cosigned by the individual shareholders, thus holding the corporation owners personally liable for the corporation's debts.

It appears that avoiding personal liability for debts is not a basic argument for incorporating farms as it is in many non-farm businesses. Given the small amount of insulation from personal shareholder liability gained by the corporations studied, it appears that shareholders immunity from liability of debts and obligations of the corporation should not be a key factor in deciding whether or not to incorporate a farm firm.

5/ J. McCord and N. S. Vazzana, Advising the Small Business Sourcebook. Practicing Law Institute, New York City, New York, 1970, p. 4.

Also, incorporating to avoid losing personal assets such as a home in case someone sued the farm operation for an injury incurred on the farm would be of no advantage if the personal assets are included as corporate property. If the personal property were excluded from the corporate assets, some insulation from casualty liability could result.

3. Employee Benefits

An important advantage frequently attributed to the corporate form of business over a sole proprietorship or partnership results from the fact that the owners of a corporation can become employees of the corporation. Consequently, as employees they are eligible to receive benefits that are tax deductible to the corporation.

Some fringe benefits have as their purpose the deferral of taxable income to a future date, normally retirement, when the employer's income is lower and taxed at a lower rate. Examples are pension plans, profit-sharing plans, and various stock bonus or stock option plans. Although a few of the farms surveyed were profitable enough to afford such programs, frequently the persons interviewed stated they thought the corporation's money could be put to better use elsewhere and thus chose not to offer employees this type of benefit.

Deferred compensation plans were once a tax advantage only for corporations but can now be used to the advantage of self-employed individuals through the use of Keogh plans and "Individual Retirement Accounts and Annuities" (IRA's). Keogh plans were liberalized and IRA's introduced in the Employment Retirement Income Security Act of 1974. This act also makes certain life insurance policies deductible for individuals which were previously deductible only for corporations.6/

A second type of benefit excludes income from being taxed at any time. Included under this heading are food, housing, group life insurance, and group health and accident insurance. The employee does not have to include the benefits received as income for tax purposes, but the corporation is allowed to deduct the cost of providing them. Corporate farms have found this type of benefit more adaptable because such benefits do not generally require as much cash drain from the operation as do pension plans and profit-sharing plans. Table 2 indicates the number of farms surveyed participating in fringe benefit plans for employees.

4. Credit Status

For most farm operations the form of business organization has little effect on financing opportunities or credit status. Seventy-six percent of the farmers interviewed stated that incorporation did not affect their credit status in any way. Three farms said incorporation was a disadvantage in obtaining credit while nine thought incorporation improved their credit position.

6/ For further information pertaining to the Employment Retirement Income Security Act of 1974, see "Retirement With Tax Advantages for Individuals", The Research and Review Service of America, Inc., Indianapolis, Indiana, 1975.

Table 2. EMPLOYEE FRINGE BENEFITS*
51 Corporate Farms, New York, 1974

Benefit	Number of Farms	Percent of Farms
House or rent	34	67%
Life insurance	27	53
Health or accident insurance	40	78
Meat, milk, or vegetables	44	86

*Received by at least 50% of employees.

Two farmers reporting that incorporation was a disadvantage in obtaining credit had a smaller asset base, and thus, less collateral after incorporation. Both farms had operating corporations, one excluded the land and the other excluded the machinery from the corporation. The third farm stating incorporation was a disadvantage in obtaining credit did not elaborate further.

The nine farms stating that incorporation was an advantage when obtaining credit gave two reasons: (1) after incorporation, one more entity was available to borrow money and (2) their bankers felt the business was a better risk because of the continuity of ownership characteristic of corporations.

Since a corporation is an artificial being, one more entity is available to borrow capital following incorporation. For example, a farm partnership with two owners has three different entities that can borrow after the farm is incorporated. Money can be borrowed by each of the two owners and the corporation itself.

Continuity of ownership gives the farm operation a more permanent form of business organization and presumably is a better credit risk. In a sole proprietorship or partnership, the death or withdrawal of one of the owners might cause termination of the business. In a corporation, succession of ownership and management may provide more practical permanence after death or withdrawal of an owner. Only one farm indicated that ease in obtaining credit was their primary reason for incorporating.7/

Although not mentioned by any of the farmers interviewed, certain types of federal loans cannot be obtained by corporations. Farm corporations are not eligible for Farmers' Home Administration real estate loans, operating loans, and rural housing loans and grants. However, if the corporation is engaged primarily in farming or ranching, they may obtain FHA soil and water loans and emergency funds.

Higher maximum interest rates can legally be charged to corporations than to individuals. Interest rates to individuals are frequently limited to the usury rate, now 8.5 percent in New York. The maximum charge to corporations is 25 percent.8/ Moreover, where the individual owners cosign the

7/ In less than nine months after the interview, the farm that had incorporated to obtain more credit filed bankruptcy.

8/ Penal Law Section 190.40, McKinney's Consolidated Laws of New York, Edward Thompson Company, Brooklyn, N.Y., 1964.

note, which is usually required by lending institutions, they also are legally subject to the higher rate. Most farmers are unaware of this fact and some have the misfortune of learning from experience after they incorporate. Six of the 51 farms interviewed were being charged a higher interest rate after incorporation than before. In all six cases, the lending institution raised the interest rate 1 percent above what they were previously charging the farm.

Disadvantages of the Corporate Form

Certain characterisitcs of the corporation have limited its widespread adoption by farm families. The two main features which have limited the corporate use are: (1) cost of legal and incorporation fees and (2) the red tape and paper work involved.[9/]

1. Costs

The principal costs of forming a corporation are usually fees for professional services of a lawyer and/or accountant. This expense can run from $300 to $1,000 or more depending upon the size and complexity of the farm business and the objectives to be satisfied.[10/] Other expenses incurred at the time of incorporation include filing fees of $50 plus $10 for initial stock issuance. All organizational expenditures, however, may be deferred and deducted ratably over a period of years to be chosen by the corporation if they so elect.[11/]

In addition to the fees and taxes stated above, other annual costs may include fees paid to an accountant or lawyer for assistance with corporate bookkeeping or tax returns. Social Security taxes to be paid by the farm business are also likely to increase after incorporation. For a self-employed individual, the Social Security tax rate is 7.9 percent. After incorporation, the corporation pays 5.85 percent on each employee, and the employee pays 5.85 percent for a total payment of 11.7 percent of each employee's salary.[12/]

In New York a tax is also imposed on the sale or transfer of stock. The rate levied when stock is sold ranges from 1 1/2¢ to 5¢ per share depending on the selling price per share. When stock is transferred from one shareholder to another but not sold, the tax is 2 1/2¢ per share.[13/] Because of the small amounts involved, this tax is of little economic importance to most farm corporations.

2. Red Tape

A characteristic of the corporate business form that many farm families do not find very appealing, although it may be to their advantage, is the increased formality and red tape required. A partnership agreement can vary from a simple document to a complex and detailed instrument, or it can simply

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9/ R.S. Smith, op. cit., p. 6.

10/ Neil Harl, op. cit., p. 78.

11/ Commerce Clearing House, Inc., Federal Tax Course - 1975, New York, NY, 1974, Paragraph 1933, p. 1916.

12/ Tax Guide for Small Business, 1975 Edition, Department of the Treasury, Internal Revenue Service, Publication 334, p. 66.

13/ Commerce Clearing House, Inc. Guidebook to New York Taxes - 1975, New be based only on an unwritten agreement. Ordinary partnership agreements do not need to be filed with any government office except in the case of limited partnerships which must be filed in the County Clerk's office.

However, if the partnership will be operating under an assumed name, it must file a "Certificate of Doing Business Under an Assumed Name" at the County Clerk's office so that those who wish to discover who the owners of the business are may readily do so. For example, if a farm partnership were to be established under any of the following names, a certificate should be filed: Happy Farms; Smith and Sons Farm; Smith, Jones and Company.

Actions and documents of a corporation, however, are generally more numerous and formal. These will usually include (among others):[14]

1. Preincorporation Subscription Agreement to be executed by the subscribers to the corporation's stock.

2. Reservation of the Corporate Name by application to Secretary of State.

3. Articles of Incorporation to be executed by the incorporators.

4. Filing of Articles with Secretary of State.

5. Issuance (by Secretary of State) of Certificate of Incorporation.

6. Recording of Certificate by County Clerk or Recorder.

7. Periodic meetings of shareholders to elect directors or to approve major corporate transactions such as sale of substantially all corporate assets or a major financing merger or dissolution.

8. Periodic meetings of directors to approve and amend by-laws, to elect officers and to approve transactions other than those taken by the officers in the ordinary course of business.

9. Filing of Annual Reports with the Secretary of State.

10. Filing in states foreign to the state of incorporation if business is to be conducted in more than one state.

In most closely held farm corporations, the limited number of principals often makes some of these formalities unnecessary and burdensome. However, most of the documents to be filed or recorded are frequently prepared by the corporation's attorney, may be quite simple, require few signatures and with the exception of annual reports need to be processed only once. In some instances, meetings of shareholders and directors can be eliminated if the action required to be taken is contained in a consent document signed by all of the shareholders or directors.

14/ Illinois Institute for Continuing Legal Education, Closely Held Corporations, Illinois Practice Handbook No. 18, Illinois Bar Center, Springfield, Illinois, 1971, pp. 1-6.

TAX CONSIDERATIONS

Tax advantages and disadvantages may be realized by incorporation. Although tax benefits derived from incorporation were indicated by only six farms as the primary reason for incorporating, taxes should definitely be taken into consideration prior to changing business form. Most tax advantages gained through incorporation, per se, are realized under an 1120 C (Regular) corporation and not an 1120 S (Subchapter S) corporation. A subchapter S corporation is treated much like a partnership for Federal income tax purposes. Therefore, tax considerations will be cited in reference to regular corporation rather than a subchapter S.

Corporate Tax Rates

As a separate legal entity, a corporation is also a separate taxpayer for income tax purposes. Until 1975, corporations have been taxed at 22 percent on the first $25,000 of taxable income and 48 percent on all income above that amount.

Nineteen seventy-five tax schedules were more favorable for farm corporations. The first $25,000 of taxable income is taxed at a rate of 20 percent and the second $25,000 is taxed at 22 percent. Profits over $50,000 are then levied a 48 percent rate. Since an individual can be taxed as high as 70 percent, the opportunity to be taxed at a maximum of 48 percent may be an appealing reason to incorporate.

However, corporate income that is paid to shareholders as dividends is subject to double taxation. The corporation pays Federal income taxes on its profits and when paid out as dividends the stockholder also pays income taxes on the same profit. The dividend income is partially offset by a $100 dividend exclusion and stockholders that are 65 or older have double income tax exemptions and also a retirement income credit.[15/]

Several opportunities exist to minimize the amount of double taxation. It is important to keep in mind that it is more difficult to withdraw money or property from a corporation than to put money into the corporation. Therefore, it is frequently advantageous to start the corporation's existence with a minimum of equity capital and a significant level of debt capital.[16/] With the capital investment low, shareholders will be less eager to withdraw funds and thus postpone the time when double taxation begins. Also, by keeping capital at a minimum, the corporation can more easily justify

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15/ For further comment see: Commerce Clearing House, Inc., Federal Tax Course - 1975, op. cit., (Paragraph 1071) Retirement Income Credit, p. 1013.

16/ For further comment see: D. R. Levi, and J. W. Looney, "Some Provisions of Subchapter C Potentially Applicable to Farm Corporations," Farm Corporations and Their Income Tax Treatment, Economic Research Service, U.S. Department of Agriculture, Washington, D.C., April 1974, p. 38.

accumulations of income as exempt from the special tax on reasonable accumulations.[17] Untaxed accumulations provide investment capital for use by the corporation that has been taxed only once.

Another opportunity for minimizing the double taxation occurs through shareholder-employee salaries. As employees of the corporation, shareholders can draw a salary that is a deductible expense for the corporation. Capital withdrawn in this manner is not double taxed since the corporation pays no tax on that portion of income paid out in salaries. However, when setting salaries to be paid by a corporation to shareholder-employees, the salaries must be kept in line with the value of the service being offered by the employee. If the Internal Revenue Service should conclude that the amount of pay received by a shareholder-employee is higher than what would be paid to a stranger, the unreasonable amount would not be deductible by the corporation and would be subject to double tax.

One tax factor to take into consideration, particularly if a business stands a chance of being unprofitable during its early years of operation, is the treatment of an operating loss. Under the regular corporate form of business, operating losses cannot be used by the shareholders to offset other income. Also, shareholders cannot take advantage of the corporation's capital gains or losses. Net long-term capital gains of a corporation are taxed at a rate of 30 percent, whereas individuals are allowed a 50 percent deduction and are then taxed at their personal tax rate.

Business Expenses

Certain expenses that are not allowable as business deductions in a sole proprietorship or partnership are legitimate expenses for a corporation. Expenses associated with farm residences frequently fall in this category and are deducted as business expenses in farm corporations. If family members employed by the corporation are living in the home for the convenience of the farm operation, then depreciation and maintenance on the home may be charged as a corporate expense. Of the 51 study farms, thirty-three included at least 50 percent of the employees' homes as corporate property so that they could take advantage of this rule.

Although including the home of employees as corporate property results in a tax advantage to the corporation, this may be an undesirable practice. Farmers in this study frequently mentioned that when several families were living in corporate owned housing, disputes between households could and often did occur over equitable accommodations. The more people involved, the more opportunity for disputes exists.

After retirement from the farm operation, some farmers want the security of having ownership of their own home. In case something should occur that could cause liquidation of the farm, several farmers pointed out that they did not want to risk losing their homes, particularly late in life.

17/ See: Commerce Clearing House, Inc., Federal Tax Course - 1975, op. cit., Paragraph 2018, Accumulated Earnings Tax, p. 2028.

Subchapter S Election

Twenty-two of the fifty-one farm corporations elected to be taxed as a subchapter S corporation. In order to make a subchapter S election, the corporation must meet a number of criteria. Those most crucial to farm corporations are:

1. No more than ten shareholders during the first five years of election and no more than fifteen thereafter.

2. Only one class of stock.

3. All shareholders must be individuals or estates.

4. No shareholder may be a nonresident alien.

5. No more than 20 percent of gross receipts can come from passive investment income, i.e., dividends, interest, rents, royalties, etc.

When the subchapter S election is made, the corporation itself is typically free from paying Federal income tax in its profits. The net income of the corporation is passed through to the shareholders proportionate to their shareholding. Capital gains are treated in the same manner. The corporation files an information return but generally pays no Federal income taxes.

Federal income tax on the corporation's earning and profits is paid by the shareholders and this is so whether or not the profits are distributed. The profits are taxed only once. No double taxation occurs as would occur in a regular corporation. Moreover, when previously taxed profits retained in the corporation are subsequently distributed to the shareholder, Federal income taxes need not be paid again at the time of distribution. However, if other than the shareholder ultimately receives payment of this previously taxed income, it could be taxed again. Thus, there is a tax hazard connected with previously retained taxed incomes if a shareholder should die or sell his stock without first having removed such income from the corporation.

Since net income in a subchapter S corporation is taxed through the individual shareholder, an operating loss of the corporation may be used to offset other income on individual shareholder tax returns. This practice is not possible in a regular corporation.

Also, due to the fact that capital gains and losses are taxed through the shareholders, capital gain taxes are levied at half the rate of the individual shareholder rather than the 30 percent regular corporation rate. As long as the shareholders are not in a tax bracket of 60 percent or higher, such treatment of capital gains can result in tax advantages to the shareholder.

One disadvantage of a subcaapter S corporation is that a new taxpayer is not created. Farms with fluctuating incomes do not have the advantage of shifting proifts between the corporation and its shareholders. Also, shareholders in high tax brackets do not have the opportunity to take advantage of the first $50,000 preferential tax treatment.

Once a corporate form is elected, switching back and forth between the two forms is restricted. The corporation must be in operation for at least one year before permission will be granted to switch corporate forms the first time. Should the shareholders decide they want to change back to the original organizational form, there is a five year waiting period restricting the